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March 23, 1995

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW - Room 222
Washington, DC 20554

RE: CC Docket No. 94-1

Dear Mr. Caton:

The Customers for Access Rate Equity (CARE) coalition hereby submits additional views regarding USTA's suggestion that the Commission annually revise the offset factor (i.e., the "X" factor) in its price cap formula through use of a rolling five-year average with a two-year lag. The most significant challenge facing the Commission in this proceeding is setting the "X" factor at the proper level. It cannot avoid that obligation by opting for a rolling average adjustment mechanism.

The price cap LECs have suggested that an annual revision to the "X" factor using a rolling average approach would better serve the public interest than retention of the sharing mechanism. But USTA's proposal suffers from serious conceptual flaws and would present enormous implementation difficulties.

Carriers have argued that limiting their earnings through sharing will cause them to become less productive because they would have to share with customers the higher earnings resulting from greater productivity. With no competition to discipline their prices, the carriers' hope is that the Commission will set the "X" factor too low, thereby allowing them to retain excess monopoly profits. In the name of efficiency, at least some of the LECs would have the Commission allow them to earn unlimited returns.

Such a result would not be possible in an effectively competitive market and would not appropriately balance the interests of carriers and ratepayers.

Economic regulation seeks to simulate, to the extent possible, the results of a competitive market. If the carriers operated in markets which were effectively competitive, competition would force them to promptly flow through productivity gains to consumers. They would not be able to retain earnings higher than the competitive market would allow. The Commission's price cap rules should produce the same results.

Updating the "X" factor annually through use of a rolling five-year average would not be as effective as "sharing" in producing these results and protecting consumer interests. Through "sharing," the Commission seeks to protect carriers and customers from both a misspecification of the industry-wide productivity factor and the unavoidable variations in carrier productivity levels. Misspecification of the price cap plan can result in consumers paying too much for interstate telecommunications services (as is currently the case under the price caps rules) or in carriers subject to the price cap rules earning at too low a level. Similarly, a uniform "X" factor, without carrier-specific sharing, could result in some carriers enjoying excessive returns, other carriers confronting deficient earnings, and customers of the former paying too much for service. A rolling average annual update to the "X" factor does not address these variability problems at all. For this reason alone, USTA's rolling average proposal should not be adopted.

USTA's rolling average is not even necessary to assure that the "X" factor reflects current productivity. If the Commission sets the "X" factor at the proper level, an annual update would be useful only if there is significant variation in the yearly productivity rate. However, there is record evidence that the industry's productivity rate since divestiture has been fairly constant. Expected gains in productivity should be captured by incorporating a "stretch factor" in the calculation of the "X" factor.

Turning to practical considerations, USTA's rolling average adjustment mechanism would present serious, probably overwhelming, challenges. If there is to be even a remote chance of verifying the annual revisions to the "X" factor required under USTA's proposal, the Commission would have to issue detailed specifications for the methodology and data sources to be used for the revisions. Carriers would have to be required to identify changes to historic values and to describe in detail the reasons for the changes. The Commission and other interested parties must be given a clear audit trail to follow. This is particularly important under USTA's proposal because significant portions of the data will likely come from non-public sources. The Commission can expect a difficult, resource-intensive process every year.

Additionally, the Commission must address the issue of how long a period would be appropriate for purposes of establishing a rolling average. Although LEC productivity has been constant since divestiture, USTA's preference for a five-year period suggests that the LECs are expecting significant productivity gains in the future. If so, a five-year rolling average with a two-year lag works against consumer interests. If adjustments are only considered annually, a five-year period would almost certainly result in the LECs retaining productivity gains and input price reductions for periods far in excess of that which would occur in a competitive market. Furthermore, the two-year lag in the availability of economy-wide productivity data from the Bureau of Labor Statistics makes USTA's two-year lag period tantamount to a four-year period.

The Commission should give no further consideration to USTA's rolling average proposal. USTA's rolling average proposal is conceptually flawed, would present significant implementation problems, and would consume scarce Commission resources. Proper specification of the "X" factor at the outset of a limited review period is the most effective way to encourage greater productivity by the LECs and to protect ratepayers' interest in just and reasonable rates.

Respectfully submitted,

Colleen Boothby

Colleen Boothby
for the CARE Coalition

cc: Chairman Reed E. Hundt
Commissioner James H. Quello
Commissioner Andrew C. Barrett
Commissioner Rachelle B. Chong
Commissioner Susan Ness

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